"A MANIFESTO FOR A NEW WAY OF THINKING ABOUT ORGANIZATIONS."
—FROM THE FOREWORD BY GARY HAMEL, AUTHOR OF *THE FUTURE OF MANAGEMENT*

SCOTT KELLER
COLIN PRICE

BEYOND PERFORMANCE

HOW GREAT ORGANIZATIONS BUILD ULTIMATE COMPETITIVE ADVANTAGE

Beyond Performance

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Foreword

Perhaps the most important question facing leaders today is this: How do you build an organization that performs flawlessly *and* evolves rapidly, one that delivers sterling results today *and* changes fast enough to be relevant tomorrow? There can be no either/or here. We live in a world that offers no refuge for mediocrity; a world in which competitors quickly and mercilessly exploit any operational weakness. We also live in an era of wrenching change: a world in which the future is less and less an extrapolation of the past. Thus what matters is not just an organization's competitive advantage at a point in time, but its evolutionary advantage over time. Trouble is, most of us know a lot more about how to build an organization that can execute in the short run than we do about how to build one that has the health and vitality to thrive over the long term.

In most industries, it's the newcomers that have been creating the lion's share of new market value and new wealth. As the barriers that used to protect incumbents from the forces of creative destruction crumble and fall, once-great companies increasingly find themselves on the defensive. Turns out a lot of companies weren't quite as invincible as they thought they were—and were overly dependent on customer ignorance, distribution monopolies, knowledge asymmetries, and other fast-disappearing sources of economic friction.

In this hyper-dynamic, hyper-competitive environment, every organization is either going forwards or going backwards—there's no standing still. Getting better is no longer enough; today, a company must be capable of getting *different*—of proactively challenging and changing the fundamental assumptions that underlie its business model. Problem is, the legacy management processes found in most organizations do little to serve the cause of proactive change.

Building organizations that are deeply adaptable, that are innovative at their core, and that are engaging, exciting places to work—building *healthy* organizations—requires some deep rethinking about how we put our organizations together. In my book *The Future of Management*, I made the case for radical management innovation. Scott and Colin have now pushed this thinking further. In their incisive and thorough work, they set out to close the gap in our knowledge about building an organization that can perform in the short term *and* thrive in the long term. Combined, they have nearly four decades of professional experience helping organizations transform themselves in pursuit of better performance and health. They have worked with organizations of all kinds—public and private, large and small—across the globe. In writing this book, they have drawn on their experience, on that of dozens of colleagues from McKinsey, and on wide-ranging research.

The result, *Beyond Performance*, is far more than a guide to leading a successful change program. It's a manifesto for a new way of thinking about organizations. Scott and Colin identify the essential components of long-term organizational health and then go on to lay out a clear plan, which, if followed, will help any organization become more vigorous and dynamic—become, fundamentally, pro-change. As the authors point out, organizational success has never been more fragile. But in *Beyond Performance* you will find a wealth of ideas that can help you lower the odds that your organization ends up marooned by the rapidly shifting tides of change.

The strengths of this book are many. The conclusions contained herein aren't hunches; they're deep empirical truths. Scott and Colin *know* what makes a healthy company. First, they have the data to prove links between specific organizational capabilities and high performance. They've drawn on a unique database of survey results from hundreds of thousands of executives who've reported how they work. The survey has been developed over 10 years and is unprecedented in its scope and revolutionary in its conclusions. The answers to the survey, combined with data regarding each company's performance over time, have enabled Scott, Colin, and their colleagues to figure out which combinations of management practices enable organizations to excel over the long term.

Second, Scott and Colin's insights have been forged in the crucible of real-world practice. There are dozens of illuminating anecdotes that give shape and heft to the book's underlying conceptual framework. One of my favorites: how to use a "story-telling cascade" to build a shared and compelling narrative about the need for change. The authors go beyond conventional wisdom to offer new insights and practical prescriptions for creating and delivering a change story, such as tapping into "five levels of meaning"—from the intimately personal to the broadly societal—and letting employees "write their own lottery ticket" to create a sense of shared ownership for bringing the story to life in their areas of influence (see Chapter 3 for more details). It's this ability to build on established practices and take them to the next level of effectiveness that sets *Beyond Performance* firmly in the tradition of management classics such as *In Search of Excellence* and *Built to Last*.

Third, the most important insights from recent scholarship on organizational change and renewal are woven into the fabric of this book. Colin, like me, has a parallel life as an academic, and is steeped in theory as much as practice. Scott has long been a management innovator, drawing on the latest research from disciplines as far afield as chaos theory and cognitive psychology to develop new tools and techniques that enable leaders to make change happen at scale in their organizations. With the support of many colleagues, they have sifted through more than 900 books and articles in the writing of *Beyond Performance*—so you don't have to. The scholarly work that will be most helpful to you is already here, in an accessible and digestible form.

And finally, while the arguments laid out in this book are clear and concise, they are never simplistic. Changing things at scale is never easy: the endeavor is always complex, perilous, and gut-wrenching. The authors know this. In the time I've spent with them—be it facilitating large group discussions in Amsterdam, conducting interviews together in London, or debating the state of management across the kitchen table at my home in California—they have always struck me as experienced, battle-tested change masters. That's why you won't find any silver bullets in this book. What you *will* find are ways to deal forthrightly and creatively with the challenges of overcoming stasis and embracing change. Scott and Colin deliver game-changing anecdotes, academic rigor, empirical research, hard facts, and novel and creative ideas on what makes a company evolve and prosper long term.

In their roles as leaders of McKinsey & Company's Organization Practice, Scott and Colin are also deeply involved in the work of the Management Innovation eXchange (www.managementexchange.com). The MIX is the world's first open-innovation platform designed to spur fresh approaches to management. So if this book sparks a new thought in your mind about how to build a company that is truly fit for the future, take a moment and share your idea with the MIX community—and help build on the great foundation that Scott and Colin have laid.

I have long believed that as human beings we are limited not by our resources but by our aspirations. The authors of *Beyond Performance* share this belief. They know that at the heart of every successful transformation effort lies a stretching and soul-stirring sense of purpose. If your purpose is to build an organization that is truly fit for the future, I urge you to turn the page and get started.

Gary Hamel
May 2011

***Gary Hamel** was recently acclaimed by the* Wall Street Journal *as the world's most influential business thinker. He is the author of the bestselling management books* Leading the Revolution, Competing for the Future, *and* The Future of Management, *and has contributed to many leading publications, including the* Wall Street Journal, Fortune, *and the* Financial Times. *He is a fellow of the World Economic Forum and visiting professor of strategic and international management at London Business School.*

Introduction

Excellence Found?

What is the greatest invention of all time? In our view, it isn't the wheel, it is organization: people working together toward a common goal. Organizations can achieve feats that go far beyond anything that individuals can accomplish alone. As each successive generation finds better and better ways of working together, it performs at levels that could barely have been imagined a few decades earlier. And when there are improvements in the effectiveness of our organizations—whether they be private enterprises, governments, public agencies, charities, community groups, political parties, or religious bodies—these gains translate into benefits for society as a whole. Innovations such as mass production, public transport, space travel, the internet, and the mapping of the human genome are all products of human organization.

Fittingly, the book you're now holding is itself the product of a collective feat of organization: many colleagues and friends have worked with us to advance the state of the art in management thinking. For Colin, this book marks the intellectual culmination of his leadership of McKinsey's global Organization Practice. For Scott, it represents a manifesto for an approach to management that he has long advocated and practiced, and at times staked his career on.

But *Beyond Performance* wasn't written for us; it was written for you. If you are a leader who wants to change things for the better, this book is for you. If you want to leave a profound and lasting legacy for your organization and its stakeholders, this book will help you do so. The concepts and approaches we describe apply broadly to anyone who leads people in an organization, whether you are the CEO of a company, the managing partner of a professional services firm, or the head of a public sector body, an activist group, a nongovernmental organization, or a social enterprise.

Much as we hope that every leader who reads the book will benefit from it, we would like its impact to ripple out still further. If we can help improve the way that people manage organizations, we hope that in some way we can also help advance the progress of society itself. It is our firm belief that the human race is capable of achieving far more by working together in the future than we are capable of achieving today.

Ultimate Competitive Advantage

This book explains, both conceptually and practically, what it means to achieve excellence in leading and managing organizations. Although a multitude of volumes have already been written on this topic, we believe no other work offers what we are trying to provide. Our approach combines two views. The first view is of a "stable equilibrium" state of organizational excellence in which high performance can be sustained; the second is of the dynamics of the transition required to reach that state. This effort is, perhaps, a kind of management equivalent to the attempt by modern-day physicists to combine classical Newtonian physics with subatomic physics in order to advance the field and develop a deeper understanding of the fundamental nature of reality. In much the same way, by combining static and dynamic views of organizations, we aim to arrive at a fuller understanding of their fundamental nature.

To that end, we aim to shift the "installed base" of management thinking. In what follows, you'll learn what management courses don't teach, at least not yet. Our central message is that focusing on organizational health—which we define as the ability of your organization to align, execute, and renew itself faster than your competitors can—is just as important as focusing on the traditional drivers of business performance. That's because, as Sir William Castell, chairman of the Wellcome Trust, puts it, "Healthy organizations get things done quicker, better, and with more impact than unhealthy ones."[1]

In this book, you learn how to set aspirations for performance and health that are unique to your organization. You learn how to assess how ready your organization is to change so that it can achieve those aspirations. You learn how to develop a powerful plan to move your organization from where it is today to where you want it to be. You master what it takes to implement this plan successfully. And you discover how to help your organization make a gradual transition to a self-sustaining state of continuous improvement in performance and health. In short, this book is a field guide to harnessing the full potential of your organization.

Unlike many business books, this book does *not* suggest that you study what other organizations do to succeed and then apply their recipe to your own situation. How many companies have analyzed how General Electric replicates its business model across multiple industries, or how Southwest Airlines delivers low-cost air travel, or how the Ritz-Carlton sets standards in customer service, or how Procter & Gamble manages its brands, without ever being able to replicate the success these companies have achieved? The answer must be "too many." Although there are always helpful things we can learn from others, the recipe for excellence in a particular organization is specific to its context: its history, the capabilities and passions of its people, its external environment, and its aspirations. Creating and sustaining your own recipe—one uniquely suited to these factors—delivers results in a way that your competitors simply can't copy (or copy at their peril). This, we believe, is where ultimate competitive advantage lies.

The forces that shape today's global economy have weakened or even wiped out our customary sources of competitive advantage. Consider the instant, often cost-free availability of information facilitated by the staggering growth (more than 20 percent per year) in the international use of internet bandwidth.[2] Such ready access to information undermines the advantage that companies have traditionally gained from smarter strategies and superior assets, which can now be copied with great speed and efficacy. The competitive advantage of the twenty-first century is increasingly derived from hard-to-copy intangible assets such as company culture and leadership effectiveness. Saad Al-Barrak, former CEO of Zain, a Kuwait-based telco, puts this well: "In the west, you can no longer create a competitive advantage with a new product or a new service, because everybody will follow suit. The level of development is so high and access to resources is so rich that cloning a product or a service takes no time. But to clone a community takes all the time in the world."[3]

Why It Matters for Business

The pace of change in business is increasing faster than ever. Consider how long an average company from the S&P 500 stays in the index. In 1955 it was estimated to be 45 years; in 1975, 26 years; and in 2009, 17 years.[4] At this rate, half of the companies that appeared in the 2010 S&P 500 Index are likely to have left it before 2020.

Moreover, in recent years many former household names have fallen not just out of a business index but out of existence: consider Enron, Digital Equipment Corporation, Lehman Brothers, Arthur Andersen, and

British Leyland. Which of today's household names will have ceased to exist in 10 or 20 years' time?

It's a question that's even harder to answer in times of rapid and far-reaching economic change. As we write, the world appears to be emerging from the most profound economic crisis since the Great Depression of the 1930s. No one knows how the situation will evolve, but there is broad consensus that the "new normal" will be characterized by increased volatility and unpredictability in capital markets, in consumer confidence, and in government policy. Charles Darwin's observation that "the fittest win out at the expense of their rivals because they succeed in adapting themselves best to their environment" may have become something of a cliché in the literature on change management, but it has never rung more true in the business world. The ability to manage an organization dynamically so that it can both shape its environment and rapidly adapt to it is becoming the most important source of competitive advantage in the twenty-first century.

Success is about winning not just in the marketplace for customers, but also in the marketplace for talented employees. The role of business in society is changing. As we work more and socialize less, the time we have left for traditional activities involving our family, our local community, and our religious institutions is declining. As a result, our sense of meaning and identity is increasingly derived from the workplace (our jobs) and the marketplace (the products and service we buy).

So work occupies a central place in our lives. But what do we expect from it? To answer this question, we surveyed more than 5,000 executives from the top 200 of their respective organizations, and asked what factors they saw as essential when deciding to join, stay with, or leave a company. Among the highest-rated factors were "freedom and autonomy" and "exciting challenges." These factors were chosen by more than half of the survey respondents, whereas less than a quarter chose "high total compensation." Among the lowest-rated factors were "high job security" (chosen by 8 percent) and "reasonable pace and low stress" (chosen by 1 percent).

The message is that talented employees are not content to be cogs in a machine geared to hitting quarterly performance numbers. They want to work in dynamic workplaces where they feel empowered to make meaningful, positive change happen. As Adam Crozier, former CEO of Royal Mail, notes, "People are looking for a sense of belonging, a sense of meaning. . . . Graduates are asking the questions, do I want to belong here? Do I see a future here? What kind of training do you give? What do you do for the community?"[5] Another CEO, Roberto Setubal of Brazil's Itaú Unibanco, concurs: "Talented people don't come here just to perform tasks. They want to offer their ideas, discuss freely, grow professionally, and contribute to the future of the company."[6]

So are we getting better at creating meaningful contexts for people to work in? Unfortunately not; in fact, we're getting worse. Take job satisfaction in the United States as an example. In 1987, 61 percent of employees reported they were satisfied with their jobs. By 2000, satisfaction was down to 51 percent. Fast-forward to 2009 and the share had dropped to 45 percent.[7] This trend holds true for all ages and income brackets.

Less satisfied is one thing, but are we at least more productive? No: between 1995 and 2009, the output of U.S. businesses increased more slowly than in any 15-year period since 1950.[8] The vast majority of developed-market economies exhibit similar trends.

As our economies emerge from recession, the ability to lead and manage organizations in a way that motivates employees and helps them be productive is more important than ever. An Ipsos Mori poll of 100 board-level directors from the 500 biggest companies in the UK reported that "attracting, motivating, and retaining the best employees" was the number-one priority for business, ahead of improving efficiency or having the right strategy.[9]

Why It Matters for Society

If we look beyond the marketplace for customers and talent to society at large, organizational excellence has never been more important. In the political process, for instance, leaders committed to change are attracting unprecedented levels of public engagement. This engagement is driven less by their personal charisma than by a growing acknowledgment that current approaches to health care, education, economic regulation, foreign relations, and other major issues simply aren't working.

In the United States, President Obama was elected on a promise of large-scale change across the whole political system. In France, President Sarkozy is driving the largest transformation project ever undertaken in the country's public sector. In the United Kingdom, leaders are pushing through a raft of reforms to change the way public institutions work, with new service agreements between ministries and central government, decentralized decision making, and broad-based efforts to improve skills.[10] In Malaysia, prime minister Dato' Sri Najib Tun Razak has introduced a program to make the government more effective and more accountable as part of the country's mission to become a fully developed nation by 2020. These are but a handful of many wholesale reforms happening at government level across the globe.

Outside politics, nongovernmental and not-for-profit organizations continue to tackle key cross-border challenges such as sustaining the environment and helping the developing world break the cycles of poverty, corruption, and inadequate education.

In the world as a whole, at least five factors are driving widespread change: the historic shift in economic growth from the developed to the developing world; the unprecedented imperative for mature economies to raise productivity to preserve living standards; the rise of new networks of hitherto unimaginable complexity for communication and trade; the increasingly urgent challenge to balance economic growth with environmental sustainability; and the expanding role of the state in regulating markets and influencing economic development. These factors are likely to continue to drive change for decades to come.

The way we respond to these challenges will have a profound effect on all our futures. Will our efforts be underpinned by organizational excellence? What are the odds of their being successful? And what will be the consequences if they aren't? What will be the social costs? And who will bear them?

Excellence Lost

Almost three decades ago, McKinsey's Tom Peters and Robert Waterman published what was to become one of the best-selling and most influential business books of all time, *In Search of Excellence: Lessons from America's Best-Run Companies.* Perhaps the book's most powerful legacy is its famous "7S framework." Having examined 43 of the Fortune 500 list of top-performing companies in the United States, Peters and Waterman identified seven factors involved in organizing a company in an effective and holistic way: strategy, structure, systems, staff, skills, style, and shared values.

Since *In Search of Excellence,* there has been a torrent of business titles providing accounts of organizational excellence and theories about what drives it. One of the best-known examples is Jim Collins and Jerry Porras's 1994 book *Built to Last,* which analyzed patterns among 18 successful companies.

Unfortunately, it seems that the recipes for excellence offered by these landmark publications provide no guarantee of staying power. It's revealing to look at what has become of the "excellent" companies lauded in the pages of *In Search of Excellence* and *Built to Last*. By 2006—well before the recent financial crisis—20 percent no longer existed, 46 percent were struggling, and only 33 percent remained high performers.[11] Why was this?

Not all of these changes in fortune can be attributed to the companies themselves, of course. Performance is partly driven by macroeconomic forces, industry attractiveness, and sheer luck. But it's also driven by the decisions leaders make, what they do and don't do, and the way they lead, which are things under every leader's control.

Our research, as we show in Chapter 1, suggests that many companies fall from grace because of an excessive bias toward a static view of managing performance. They synchronize their "7S" dials to deliver against quarterly and annual targets instead of taking a more dynamic view that encompasses not only their company's performance but also its health: its ability to align, execute, and renew itself faster than the competition.

So if organizations need to take a more dynamic view of excellence, how can they achieve it? This takes us to the question of how leaders make rapid, large-scale change happen, and how they develop cultures of continuous improvement.

In 1996, when John Kotter published *Leading Change*—widely considered to be the seminal work on change management—he reported that only 30 percent of all change programs succeed. Fifteen years later, we can choose from more than 25,000 books on organizational change, and hundreds of business courses on how to lead and manage it. In spite of this abundance of advice, all available research suggests that—you guessed it—still only one in three programs succeeds. The field of change management, it would seem, hasn't really changed a thing.

Only a third of excellent companies remain excellent over the long term. Even fewer change programs succeed. Why is this?

We don't claim to have all the answers, but at this point in our research efforts, we're confident that we do have insightful (beyond common sense) and pragmatic (readily applicable) advice that will help leaders beat these odds and achieve sustained organizational excellence. In fact, we've observed so many successes in so many industries and from so many different starting points using the approaches we describe that we regard successful transformation and sustained excellence as a real possibility for almost any organization.

The Science of Organization

The world of management is rife with opinion and conjecture. In writing this book, we have endeavored not only to draw on our own experience as management consultants, but to ensure that our arguments are as objective and fact-based as possible. Whereas *In Search of Excellence* was based on a study of 43 American companies and *Built to Last* on 18, this book draws on a much broader array of evidence. We have had the benefit of the results of surveys on the drivers of organizational performance and health from more than 600,000 respondents from more than 500 organizations across the globe, surveys on the experience of transformational change from more than 6,800 CEOs and senior executives, reviews of more than 900 books and articles from academic journals, one-on-one interviews with 30 CEOs and other senior executives who shared their personal experiences of leading change and driving performance, data and learning from more than 100 clients served by McKinsey on engagements specifically related to performance and health, and close working relationships with four eminent scholars who helped to challenge and augment our findings. In fact, we are confident that *Beyond Performance* represents the culmination of one of the most extensive research efforts ever undertaken in this area.

We realize that most of our readers will be more interested in the practical lessons we can draw from the research than in the research itself, so most of the book focuses on helping leaders get better results from their organizations. However, Chapter 2 provides details of our sources and methods for anyone who is interested in our fact base and technical approach. Other readers may want to skim through this section to understand the evidence base that underpins the assertions we make.

■ ■ ■

If this book helps more organizations to become and stay excellent, and more change programs to succeed, it will have done its job. If it also helps people make faster progress in tackling the major social and political issues of our time, it will have achieved everything we could have hoped for. But setting these grand aspirations aside, if you put this book down feeling that you are better equipped to make a positive difference in the world through the way you lead and manage your organization, we will feel that our work as authors has been accomplished.

PART I

Why Performance Is Not Enough

CHAPTER 1

The Big Idea

Performance and Health

In early 2004, the Coca-Cola Company was struggling. Since the death of CEO Roberto Goizueta in 1997, its fortunes had suffered a sharp decline. Over that seven-year period, Coke's total return to shareholders stood at minus 26 percent, while its great rival PepsiCo delivered a handsome 46 percent return. Two CEOs had come and gone. Both had overseen failed transformation attempts that left employees weary and cynical. A talent exodus was under way as leaders in key positions sought to join winning teams elsewhere.

At this less than auspicious moment, enter Neville Isdell. As vice chairman of Coca-Cola Hellenic Bottling Company, then the world's second-largest bottler, he had enjoyed a long and successful career in the industry. Since retiring from that role he had been living in Barbados, doing consultancy work and heading his own investment company. However, the opportunity to lead the transformation of one of the world's iconic companies was a powerful lure, and he was soon installed in the executive suite at headquarters in Atlanta.

Isdell had a clear sense of what needed to be done. The company had to capture the full potential of the trademark Coca-Cola brand, grow other core brands in the noncarbonated soft drinks market, develop wellness platforms, and create adjacent businesses. But how could he follow these paths to growth when his predecessors had failed?

Experience told him that focusing solely on improving performance wouldn't get Coke where it needed to be. There was another equally important dimension that wasn't about the performance of the organization, but its health. Morale was down, capabilities were lacking, partnerships with bottlers were strained, the company's vision was unclear, and its once-strong performance culture was flagging.

Just a hundred days into his new role, Isdell announced that Coke would fall short of its meager third- and fourth-quarter target of 3 percent earnings growth. "The last time I checked, there was no silver bullet. That's not the way this business works," Isdell told analysts.[1] Later that year, Coke announced that third-quarter earnings had fallen by 24 percent, one of the worst quarterly drops in its history.

Having acknowledged the shortfall in performance, Isdell ploughed onward, launching what he called Coke's "Manifesto for Growth." This outlined a path to growth showing not just where the company aimed to go, but what it would do to get there, and how people would work together along the way. Working teams were set up to tackle performance-related issues such as what the company's targets and objectives would be and what capabilities it would require to achieve them. Other teams tackled health-related issues: how to go back to "living our values," how to work better as a global team, and how to improve planning, metrics, rewards, and people development to enable peak performance. The whole effort was designed through a collaborative process. As Isdell explained, "The magic of the manifesto is that it was written in detail by the top 150 managers and had input from the top 400. Therefore, it was their program for implementation."[2]

It wasn't long before the benefit of addressing performance and health in an integrated way became apparent. Shareholder value jumped from a negative return to a 20 percent positive return in just two years. Volume growth in units sold increased from 19.8 billion in 2004 to 21.4 billion in 2006, roughly equivalent to sales of an extra 105 million bottles of Coke per day. By 2007, Coke had 13 billion-dollar brands, 30 percent more than Pepsi. Of the 16 market analysts following the company as of July 2007, 13 rated it as outperforming, and the other three as in line with expectations.

These impressive performance gains were matched by visible improvements on the health side. Staff turnover at U.S. operations fell by almost 25 percent. Employee engagement scores saw a jump that researchers at the external survey firm hailed as an "unprecedented improvement" compared with scores at similar organizations. Other measures showed equally compelling gains: employees' views of leadership improved by 10 percentage points to 64 percent, and communication and awareness of goals increased from 65 percent to 76 percent.

But the biggest change could be felt in the company's halls. In a 2007 interview, Isdell noted that "When I first arrived, about 80 percent of the people would cast their eyes to the ground. Now, I would say it's about 10 percent. Employees are engaged."[3] When he returned to retirement in July 2008, he was able to hand over a healthy company that was performing well.

The Health of Organizations

Neville Isdell's actions at Coca-Cola revealed his intuitive grasp of a great paradox of management. When it comes to achieving and sustaining excellence in performance, what separates winners from losers is, paradoxically, the very focus on performance itself. Performance-focused leaders invest heavily in those things that enable targets to be met quarter by quarter, year by year. What they tend to neglect, however, are investments in company health—investments in the organization that need to be made today in order to survive and thrive tomorrow.

Perhaps surprisingly, we have found that leaders of successful and enduring companies make substantial investments not just in near-term performance-related initiatives, but in things that have no clear immediate benefit, nor any cast-iron guarantee that they will pay off at a later date. At IT and consultancy services company Infosys Technologies, for instance, chairman and chief mentor N. R. Narayana Murthy talks of the need to "make people confident about the future of the organization" and "create organizational DNA for long-term success."[4]

So why is it that focusing on performance is not enough—and can even be counterproductive? To find out, let's first look at what we mean by performance and health.

Performance is what an enterprise delivers to its stakeholders in financial and operational terms, evaluated through such measures as net operating profit, return on capital employed, total returns to shareholders, net operating costs, and stock turn.

Health is the ability of an organization to align, execute, and renew itself faster than the competition so that it can sustain exceptional performance over time.

For companies to achieve sustainable excellence they must be healthy; this means they must actively manage both their *performance* and their *health*. Our 2010 survey of companies undergoing transformations revealed that organizations that focused on performance and health simultaneously were nearly twice as successful as those that focused on health alone, and nearly three times as successful as those that focused on performance alone.[5]

High performance is undoubtedly a requirement for success. No business can thrive without profits. No public sector organization can retain its mandate to operate if it doesn't deliver the services that people need. But health is critical, too. No enterprise that lacks robust health can thrive for 10, 20, or 50 years and beyond.

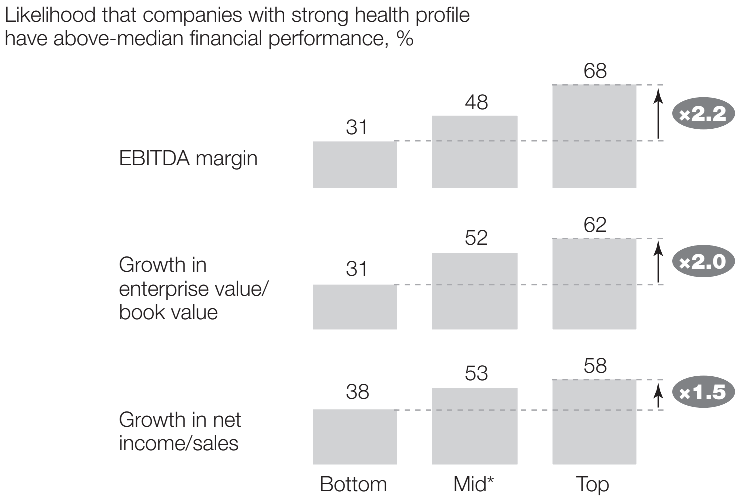
In fact, we would argue that strong financial performance can have a perverse effect: it sometimes breeds a degree of complacency that leads to health issues before long. In the months before the 2008 economic crash, the financials of most banks were at record highs. Similarly, oil at record prices of more than US$200 per barrel led the oil majors to declare record profits. As it turned out, this didn't mean that the banks and the oil companies were in the best of organizational health.

The importance of organizational health is firmly supported by the evidence. When we tested for correlations between performance and health on a broad range of business measures, we found a strong positive correlation in every case. For example, companies in the top quartile of organizational health are 2.2 times more likely than lower-quartile companies to have an above-median EBITDA (earnings before interest, taxes, depreciation, and amortization) margin, 2.0 times more likely to have above-median growth in enterprise value to book value, and 1.5 times more likely to have above-median growth in net income to sales (Exhibit 1.1). Across the board, correlation coefficients indicate that roughly 50 percent of performance variation between companies is accounted for by differences in organizational health.

The results from our large sample of companies are mirrored by the results within individual organizations. At a large multinational oil company, we analyzed correlations between performance and organizational health across 16 refineries. We found that organizational health accounted for 54 percent of the variation in performance (Exhibit 1.2).

So strong is this relationship between performance and health that we're confident it can't have come about by chance. We'd be the first to admit that correlations need to be treated with caution. Take an example: education and income are highly correlated, but that doesn't mean that one causes the other. It's just as logical to argue that a higher income creates opportunities for higher education as it is to argue that higher education creates opportunities for a higher income (and even if it does, we can't infer that everyone who gains more education will have a higher income).

Exhibit 1.1
Healthy Companies Perform Better



* Comprised of second and third quartiles

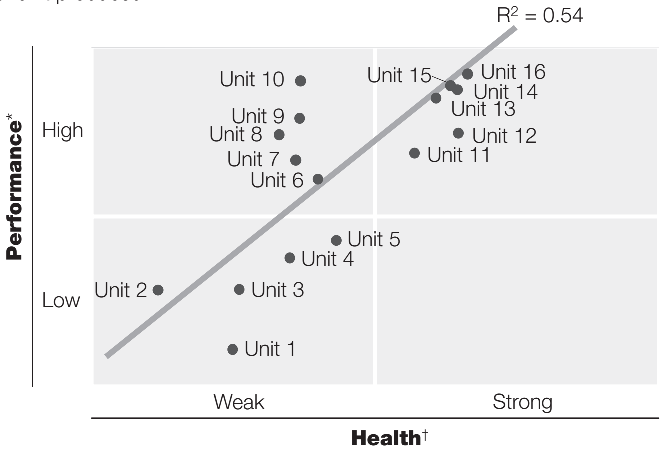
But our argument doesn't rely solely on correlations. On the strength of our research and analysis, we assert that the link between health and performance is more than a correlation, and is in fact causal. We argue that the numbers show that at least 50 percent of your organization's success in the long term is driven by its health, as we see in Chapter 2. And that's good news. Unlike many of the key factors that influence performance—changes in customer behavior, competitive moves, government actions—your organization's health is something that *you* can control. It's a bit like our personal lives. We may not be able to avoid being hit by a car speeding round a bend, but by eating properly and exercising regularly we are far more likely to live a longer, fuller life.

To shed more light on this causal link, here's an anecdote from our own experience. At McKinsey, we hold an internal competition called the Practice Olympics to develop new knowledge. A "practice" is a group of consultants dedicated to a specific industry (such as financial services) or function (such as strategy). In the Practice Olympics, teams of consultants

Exhibit 1.2
Impact of Health on Performance at Business-Unit Level

Example: Refineries at an oil company

US$ per unit produced



*Relative to industry average
†Relative to OHI database average

compete to develop new management ideas and present them to a panel of judges at local, regional, and organization-wide heats. In 2006, the topic of performance and health made it through to the last round.

A few days before their final presentation, the performance and health team decided to add in an extra ingredient. Rather than drawing conclusions from a retrospective view of performance and health at various organizations, they asked themselves, “If we look at the health of today’s high-performing companies, what does it tell us about their prognosis for performance in the future?” After reviewing publicly available information about Toyota, the team concluded that it would face performance challenges within the next five years. What were the reasons for this seemingly unlikely verdict? The team noted that Toyota’s strong focus on execution meant that its organizational health was partly driven by how well it developed talent in key positions—something that was likely to come under strain before long because of the way it was pursuing performance.